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**Needed Reform in the
Present Federal Tax Laws**

**Guaranty Trust Company
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Measures Which Should Be Taken to Re-
lieve Business From Unwarranted
Burden of Existing Taxation

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IMMEDIATE reforms in Federal taxation are necessary if business is to progress and expand sufficiently to meet the demands for increased production. To continue, during peace times, the taxation of business profits upon a war basis, means to injure American business and industry beyond reparation. All clear thinking Americans must realize that we are now passing through one of the most critical periods in American history. Social unrest is becoming more and more pronounced, and the demands of labor must be met by a division of the earnings of industry and commerce. The claims of labor cannot be satisfied if business is to be indefinitely burdened as at present, with taxes so high as to discourage

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enterprise and retard production. Nothing can help solve the present unstable social conditions better than largely increased production, but business concerns cannot be expected to accept the hazards of extensive expansion and at the same time pay to the Government a large proportion of their profits in the form of excess profits and income taxes.

Militates Against Foreign Trade

Moreover, our high taxes militate against the expansion of our foreign trade, which at this time is so important to the future prosperity of our industries. The high rates for money which are demanded by the investor because of heavy taxation, deter the opening of commercial credits and the free investment in foreign securities. In fact our own industries are precluded from financing by bond issues, except at excessive rates, which overcome, in a measure, the tax of the individual investor, and they have recently favored the raising of capital by the issue of preferred stock which is less expensive. The high rate of return on such stock also is proving attractive now to investors who formerly would invest only in high-grade bonds, thus demonstrating that high rates of tax are inclined to cultivate speculative tendencies, rather than encourage caution and thrift. And even with the inducement of high return, capital has been, to a considerable extent, diverted

from investment in industries to investment in securities which are exempt from tax.

To retain, at this time, taxes which are so injurious to our economic welfare, is unjustifiable and immediate remedy should be afforded by Congress. Great Britain has recognized the necessity of such reform, and in the last budget there was included a provision for a 50 per cent. reduction of the war profits tax. In introducing this budget, the Chancellor of the Exchequer stated, in effect, that the existing high tax deterred enterprise, industry, and development. The statement of the Chancellor can be applied with equal force to American industry.

Repeal of Excess Profits Tax

One of the most urgent reforms in our present system of taxation is the repeal of the excess profit tax. This tax, in its present form, though probably justifiable as a means of raising revenue for the prosecution of the war, is both unscientific in principle and economically unsound. Although this tax is in the form of a direct tax on profits, it is, in effect, a most unsatisfactory commodity tax. A manufacturer or merchant or other business concern subject to the tax is required to estimate in advance the amount which he is compelled to add to the selling price of the commodity and to pass the same on to the ultimate consumer, in order to protect himself against the heavy im-

sition. Because of the uncertainty of the determination of tax owing to the intricacies and complexities of the law, a business concern is apt to overestimate, rather than underestimate, its liability. In doing this, it becomes an unintentional profiteer in protecting itself from an undue usurpation of its earnings. If we abolish the excess profits tax, we undoubtedly will have eliminated a potent factor in the existing high cost of living.

Penalizing Credit

Furthermore, the excess profits tax law, as framed, penalizes credit. It says, in effect: "If you are a corporation whose credit is good, and you expand your business through loans, we will give you no allowance for capital so raised and employed, but we will tax you on your profits to the same extent as if this borrowed capital did not exist." On the other hand, a concern which is unable to borrow may get the full benefit of all capital which is invested in the business by the stockholders. There is no question that the income of the first business may be increased directly by the investment of borrowed money made possible by the borrowing ability of the corporation. Yet, the corporation in the second instance, which has no credit, will have the same exemption and will be taxed at proportionately lower rates than the first corporation. The law, with its present limitations on invested capital, not only gives no

recognition to a concern which can expand its business by credit, but unjustly imposes a heavier burden upon such business than upon a business which is unable to obtain credit. This is but another flagrant example of the tendency of this law to deter expansion and thus retard production.

Many Inequalities Produced by Excess Profits Tax

The inequalities produced by the excess profits tax law are so many that it is impossible to enumerate all of them. In fact, they become more apparent with the age of the law. The effect of the application of the excess profits tax is often the result of chance in the organization of the corporation, or the age of the corporation. For example, a corporation organized in 1912, having no knowledge of the form which future revenue legislation would take, may have capitalized at \$500,000 and issued bonds for an additional \$500,000. A competing corporation, engaged in identically the same business, may have organized at the same time, capitalizing at \$1,000,000 by issuing \$500,000 in common stock and \$500,000 in preferred stock, instead of bonds. In the first case, provided the surplus and undivided profits of the two corporations are the same, the invested capital of the corporation issuing bonds will be \$500,000 less than the invested capital of the corporation which

issued preferred stock. If the net income of the two competing corporations is the same, the tax on the latter corporation will be reduced because of the difference in the invested capital. Here we have two corporations with the same amount of capital originally invested and employed in the business, one of which is taxed in excess of the other because of the nature of its capital.

Again, we may take a corporation organized in 1904 with a paid-in capital of \$2,500,000. The actual value of the property paid in, consisting of plant and other property, on January 1, 1919, due to appreciation, is \$5,000,000. In 1918, a corporation engaged in the same business is organized with a paid-in capital of \$5,000,000 invested in plant and other tangible property of equal value. Although the capital invested at the beginning of the taxable year is the same in each corporation, the corporation organized in 1904 is allowed to include in invested capital for excess profits tax purposes only the original \$2,500,000 paid in, without taking into consideration the increased value of its assets due to appreciation. The corporation organized in 1918, with assets of no greater value than the other corporation, may compute its excess profits tax on the basis of a \$5,000,000 capitalization. The excess profits tax at the rates for 1919, assuming that each corporation earns \$1,500,000, will be \$459,400 for the corporation organized in 1904, and \$319,400 for

the corporation organized in 1918, although the business is the same and the assets and earnings of the corporations are of like amounts.

*Inequalities Affecting Good-Will,
Trade Marks, Etc.*

Inequalities also exist in many cases of corporations which, through long established business, have built up valuable good-will and trade marks, and of newly organized corporations which have purchased assets of going concerns, including good-will and trade marks. For example, a corporation may have been in existence for twenty-five years and have acquired, through extensive advertising and reputation for service and business methods, good-will of a market value of \$1,000,000. The value of this good-will cannot be considered in the computation of invested capital. The following year a going corporation may purchase the assets of the first corporation, paying for the good-will the sum of \$1,000,000 cash. This corporation would be entitled to include the value of the good-will so purchased as invested capital. Many cases now exist in which valuable good-will with immense earning power cannot be considered in the computation of invested capital, whereas other corporations which have purchased good-will for cash are allowed to include such good-will

at its cost, thus working a particular hardship on many competing corporations.

The practice also of assessing different forms of business organization by different methods of taxation, as at present, produces inequalities in competing firms and corporations. For instance, a corporation having invested capital of \$50,000 and profits of \$20,000 would pay a tax of \$4,680 based on the 1919 rates, whereas if the same business were conducted by two partners, each sharing equally in the profits and having no other income, the tax paid by each would be approximately \$590, or a total tax of \$1,180. In this case the corporation is taxed more than 300 per cent. higher than a partnership engaged in the same business would be taxed. This is true in the case of smaller corporations. In certain cases, however, a partnership whose earnings are large will be taxed higher than a corporation whose stock is held in the same proportion as the interest of the individual partners in the partnership.

Aside from the fundamental objections to the excess profits tax, the administration of the law is both difficult and intricate. The computation of a tax, based on invested capital arbitrarily defined and net income, is necessarily so complicated as to be practically unintelligible to the average business man who has neither the time nor the inclination to work out the problems with which he is confronted in the preparation of his tax return. This

is especially true with respect to placing a valuation on invested capital.

Excessive Burdens Imposed on Incomes

Based on the estimates of the Administration, approximately 35 per cent. of the cost of the war has been borne by current taxation. This is a greater amount than the original program called for, and is due largely to the ease with which a legislature may increase the rates of taxation on incomes without realizing the ultimate effect of the high assessment. To continue to raise such enormous sums of revenue by means of an assessment on incomes will place a greater burden on posterity by impeding the industrial growth of the country than would the passing to them of a larger contribution to the war debt than is now contemplated.

The entire elimination of a tax on income is, of course, not to be considered, as income taxes must be recognized to have become a permanent part of our Federal revenue system. Such taxes, however, must be kept within reasonable limits, and where revenue is needed beyond an amount which may be properly and logically raised by this means, other sources of taxation should be considered. Unquestionably, our present rates of tax are unduly oppressive to business, and if the amount of revenue now estimated to be necessary to keep

our Government functioning must be forthcoming, other methods of taxation should be adopted.

Gross Sales Tax Recommended

Ample revenue may be raised and our excess profits tax abolished and income tax lowered by the enactment, in lieu thereof, of a consumption tax, in the nature of a tax on gross sales. It is estimated that a general consumption tax, based on gross sales, at the rate of 1 per cent., would yield amounts varying from \$1,250,000,000 to \$3,500,000,000 annually, depending upon the extent of the application of the tax, the former amount being realized if the tax were confined exclusively to retail sales, and the latter amount if applied to all turnovers. A tax of this character is so evenly distributed that it would be felt but little; at the same time it would be most productive. In most cases the tax would be passed on to the consumer, who would pay the small assessment as a part of the cost of the product. It would be so light, however, that it would hardly be realized. In many cases the amount paid would be so small that the cost of the goods would probably not be increased, but the tax would be borne by the seller or producer. In all cases competition could be depended upon to prevent any excessive increases in the cost of products or merchandise on account of the tax.

In addition to the uniformly equitable character of the tax, the administration and enforcement of

a law of this character would be simple and would relieve both the public and the Government from the unnecessary confusion and expense incidental to a law involving the intricate and complex provisions of the excess profits tax. With the reduction of the expenses of the Government which will come with the resumption of normal conditions, the gross sales tax may be repealed and the needs of the Government met by the revenue derived from income taxes and import duties.

Remove Tax on Reorganizations

In addition to the elimination of the excess profits tax and a general reduction of income tax, a number of objectionable features in the present law should be remedied by legislation. One of the most important of these is the repeal of Section 202 (b), which provides that taxable income shall accrue when, in the case of any reorganization, merger, or consolidation of a corporation, a person receives, in place of stock or securities or securities owned by him, new stock or securities having a par or face value in excess of the aggregate par or face value of the stock or securities exchanged. In such case the law now provides that a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market

value of the new stock or securities is greater than the cost or fair market value on March 1, 1913, of the stock or securities exchanged. This provision is holding up many reorganizations, consolidations, and mergers, because stockholders refuse to run the risk of paying a large tax on a paper profit which has not been realized.

This provision should be eliminated for two reasons: First, it is doubtful if any taxable income accrues within the meaning of the law; and, second, it prevents desirable rearrangements of business which are essential at the present time to industrial expansion. The stockholder in the case of a reorganization or consolidation receives only a certificate of stock evidencing an interest in the same property the ownership of which was evidenced by the certificate which he has surrendered. There is no separation of the capital invested in the stock and the appreciation in the value of the stock exchanged which is essential to the realization of income within the meaning of the taxing act. In other words, the exchange of stock is merely an exchange of an evidence of the ownership of an interest in the same property.

There is a decided difference in an exchange of securities under these conditions, and an exchange of a readily marketable security of one kind for a marketable security of another. In the latter case, it would be possible in many cases for a person to avoid paying any tax on an exchange of invest-

ments if, instead of selling a stock outright, he should arrange to exchange it for the stock of another corporation of an equal market value.

The existence of this provision has been the cause of various methods being adopted to avoid payment of tax in the case of a reorganization consolidation, or merger. One of these methods is the incorporation under the law of a state under which stock of no par value may be issued without requiring a corporation to fix in a certificate, or on its books of account or otherwise, an amount of capital or an amount of stock issued which may not be impaired by the distribution of dividends. The Department has recognized in its regulations this method of reorganization as possible, without the payment of tax. If, however, a corporation does not desire to adhere to these conditions, it is necessary for the stockholders either to refrain from reorganization or to submit in many cases to an extremely high tax on profits which are not realized.

Present Tax on Profits from Sale of Capital Assets

A change in the law should also be made in the method of assessing profits derived from the sale of capital assets. Under the present law the profits realized from the sale of capital assets are subject to tax at the rates effective for the year in which such property is sold, regardless of the

fact that such profits may be derived from the sale of property acquired many years ago. To tax, at the very high rates now existing, profits accrued over a period of years, is not only unfair, but has prevented the sale of property which otherwise would have changed hands. The result is that the Government receives no revenue in such cases, and improvements which would result from such transfers are prevented. An equitable method of assessment should be adopted. The fairer method, undoubtedly, would be to prorate the profits over the period during which the property has been held and assess and collect tax on the proportionate profits attributable to the particular year at the rates effective for such year. By this means an accumulation of profits for a number of years would not be assessed as a whole in one year. Other methods have been suggested, but this would seem to be the most equitable.

Taxation of Non-resident Income

With the increasing popularity of income taxation throughout the world it has become imperative that uniformity should exist in the methods of taxing non-residents. Dual taxation can be averted only by the nations which impose an income tax, recognizing the laws of one another to the extent that income should have but one situs for the purpose of taxation. Under existing laws it is not an uncommon incident to see the English and Ameri-

can income tax exceed the net income of the taxpayer. To remedy this condition, a uniform^s practice of taxing nonresident aliens should be considered and adopted at an early date by a *commission composed of representatives from all countries imposing an income tax*.

There is no question that on income derived from business engaged in or transacted in a foreign country a non-resident alien should be required to pay a tax to the country in which he is carrying on such business and in which he derives the income. He should, however, not be required to pay tax again on this income to another country. To a certain extent, this has been remedied by our present income tax law, so far as citizens of the United States living in this country are concerned, but the law should be amended to give complete relief in all cases.

An entirely different situation exists, however, in the case of taxation of income derived from stocks and bonds of domestic corporations owned by non-resident aliens. Under the Federal income tax law of 1913 as interpreted by the Attorney General of the United States, the income from stocks and bonds of domestic corporations owned by non-resident aliens was not subject to tax. The Treasury Department, however, in 1916, refused to follow longer the opinion of the Attorney General and insisted upon the collection of tax on such income. In the Act of 1916 and the Act

of 1918 such income was made specifically subject to tax. Prior to the war, American securities in large volumes were purchased and held in foreign countries. and when the proper time arrives, we will again desire to market securities in foreign fields. The present tax, if retained, so discriminates against American securities that it will seriously interfere with their marketability abroad, and it is therefore of vital interest to this country that this provision of the law should be repealed.

Tax on Interest of Non-resident Alien Bank Deposits

The phase of the tax on non-residents which is now probably of greater concern than any other is the tax on interest on bank deposits of non-resident aliens. The continuance of a tax of this character is injurious to the general industrial prosperity of the country and particularly to the promotion of foreign trade. In the first place, a bank's deposits constitute a part of its operating capital, and any governmental policy which tends to decrease the amount of such deposits has a detrimental effect, not only upon the bank itself, but also upon all collateral lines of business.

At the present time export credit is an important factor in the United States and anything which tends to check such credit is disastrous to the foreign trade of this country. To satisfy the

demands of American exporters, in many cases, it is necessary that foreign deposits be maintained in New York. As a matter of practice, many American exporters insist upon receiving payment in New York for goods destined for overseas markets. In order to meet this situation, the foreign buyer, through his local bank, has money on deposit in New York and arranges for the seller in the United States to draw here, the New York bank debiting the foreign account accordingly.

It is not attractive to the European banker to place his money, in normal times, in a country where he is required to pay a tax on the interest which he receives on his balance, and it is not unlikely that he will instruct his customers to purchase in some other market. If the situation is not remedied there is grave danger that many of these foreign banks will transfer their accounts to banks outside of the United States where such tax is not imposed.

The benefits derived from this tax because of the revenue which it produces are entirely disproportionate to the detrimental effects produced upon the instrumentality upon which it is levied. The amount which the tax produces is comparatively small. The amount of income, however, derived indirectly from such deposits is large. If these deposits are removed, the Government will lose not only the tax on the interest on such deposits, but will lose a very much heavier tax on the

profits which American business concerns derive indirectly from the maintenance of such deposits in this country. It is advisable, therefore, not only from the point of view of American industry but from the point of view of the United States Government that these objectionable features of our Federal law be immediately repealed. Other changes in the law to prevent dual taxation of non-residents are desirable, but those stated above are of the greatest importance at the present time.

A Single Graduated Tax Preferable

In addition to the fundamental defects in the present system of taxation which have been suggested, certain changes may well be made in the present law which will be of marked advantage from the standpoint of simplicity and ease of administration. A most desirable change is the form of the present income tax. The existing law in effect provides for two separate taxes, a normal tax and a graduated surtax. This distinction is confusing to the taxpayer and results in unnecessary complications with respect to the computation of the tax. The reason for differentiating between those two classes of taxes, under the original income tax law, was for the purpose of the collection of tax at the source. As the collection of tax at the source has been abolished, with the exception of tax on the income of a non-resident alien, and interest on "tax free" covenant bonds,

the classification of normal and surtax is no longer necessary or advisable. The law could be amended to provide for a single graduated income tax, with proper credits for tax on account of income derived from dividends on stocks of domestic corporations and interest on Liberty Bonds, which would simplify the existing provisions by eliminating a useless distinction.

Among other amendments of the law which are advisable is the continuance of the present provision of the law, expiring in 1920, which permits the allowance of a net loss in one year against the net income of the following or preceding year, and the extension of the period of thirty days from date of discovery to one year from such date within which the fair market value of mines, oil and gas wells, must be determined for the purpose of the depletion allowance.

